HowToTrade

FRACTAL TRADING STRATEGY [PDF]

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Fractal Trading Strategy

The concept of fractals in trading is more accessible and practical than it might initially seem. To understand how fractals play a crucial role in trading, we must first know what they are and why they matter.

This fractal trading strategy pdf guides you into all of that and some more.

What is Fractal in Trading?

Fractals in trading were popularized by Bill Williams, a renowned trader and author of "Trading Chaos." Williams introduced the concept of fractal analysis as part of his broader trading system, which also included other elements like the Alligator Indicator and the Awesome Oscillator.

One of the key insights from the Bill Williams Fractal is that it can help traders identify potential reversal points in the market. When a valid fractal pattern appears, the balance between buying and selling pressure may shift. It is essentially a candlestick chart pattern, which was, over time, developed as an indicator that is available on many trading platforms.

How To Identify Fractals on the Chart

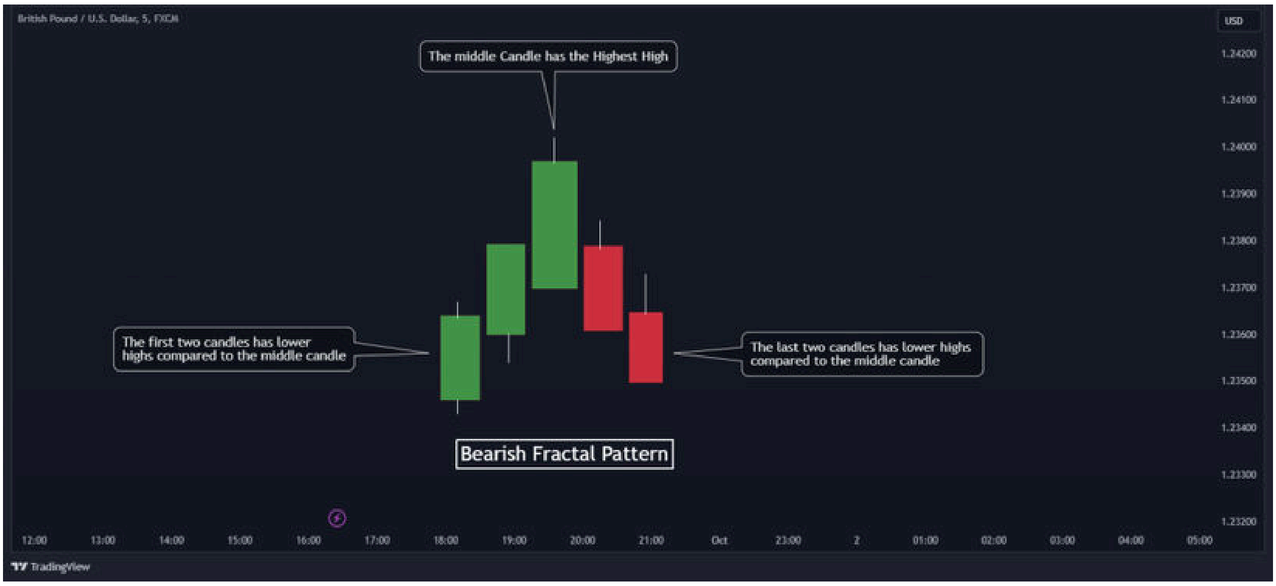
Fractal forms in two distinct methods: bullish and bearish patterns. A bullish fractal signifies an impending uptrend reversal. To spot it on your price chart, look for a series of five candles. The third candle should be the one with the lowest low.

This marks a potential reversal point. The first two candles within the pattern must show higher lows compared to the middle candle. Finally, the last two candles should also have higher lows, further confirming the growing bullish momentum.

The chart below shows how it looks on the chart:

Conversely, a bearish fractal signals an imminent downtrend. Here's how to identify it: Start by identifying a series of five candles. In this case, the third candle should have the highest high, signaling a potential trend reversal. The initial two candles in the sequence should have lower highs than the middle candle. Lastly, the last two candles should continue the pattern by showing lower highs.

Check the chart below to see what it looks like.



It is important to note that the color of the first and second candles does not matter when identifying the fractal pattern. For example, a bullish fractal can have a bullish candle followed by a bearish candle just before the middle candle, and it is still a valid bullish fractal pattern as long as the lows are higher than the middle candlestick's low.

Now, thanks to Williams, you can also automatically plot these patterns on your chart by simply adding the Williams Fractal indicator to your favorite charting software. To add it

to MetaTrader4 or 5, you must look for a third-party source and install it as a custom indicator.

The chart below shows the "Williams Fractal" on TradingView.

A bearish fractal, also known as an up fractal, is typically represented on a chart with an upward-pointing arrow above it. Conversely, a bullish fractal, known as a down fractal, is depicted with a downward-pointing arrow below it.

Consequently, if you're using fractals within an uptrend, focus on identifying the downward-pointing fractal arrows. Conversely, when looking for trading opportunities with bearish fractals in a downtrend, look for upward-pointing fractal arrows.

How to Use Fractals in Trading (2 Most Common Ways)

Now that you know how to identify fractals on the chart, let's see how to trade them profitably. It's important to note that there are many ways to trade these patterns, many of which involve combining the strategy with other technical analysis tools. However, these are two of the most effective fractal trading strategies:

1. RSI and Fractal Trading Strategy

A basic fractal trading strategy is to combine the concept with the RSI indicator. The RSI indicator is good at showing us where price reversals are likely to take place, and armed with the fractal pattern; we can take advantage of the new move.

The first step is to identify overbought or oversold levels on the RSI. These points signal a potential reversal. For instance, from the chart below, we can see an oversold market telling us that the sellers are leaving the market and an uptrend is about to start.

After identifying the market is oversold, we will be looking to enter a buy entry at the close of the fifth candlestick of the bullish fractal pattern, as shown in the chart below.

Knowing where to buy is not enough; we must also pay attention to our risk management parameters, as this is not a fail-proof strategy.

In this case, our stop loss will be placed slightly below the bullish fractal pattern, and we will exit the position when the RSI is overbought. If you prefer a “set and forget” approach, you can set your target profit to two times your risk after placing your stop loss below the bullish fractal pattern.

2. Fibonacci Retracement and Fractal Trading Strategy

Another method to use the fractal trading system is to combine it with Fibonacci retracement levels. This strategy combines the power of fractal trading as a trend reversal indicator with the precision of Fibonacci retracement levels, helping to narrow down trade possibilities to higher probability setups only. Here’s how this strategy works:

The first thing you want to do when you hit the chart is to identify the trend. In a downtrend, we have a series of lower highs and lower lows. On the other hand, a series of higher highs and higher lows signal an uptrend.

From the above chart, it’s clear that the trend is bearish, and all we have to do is look for a bearish fractal pattern.

After identifying the bearish fractal pattern, it's time to add a Fibonacci retracement confluence. In a downtrend, draw the Fibonacci retracement from the swing high to the swing low. The pattern must be retesting key Fibonacci retracement levels (e.g.61.8%) to be a valid entry signal, as shown in the chart above. Then, open a position after the close of the fifth candle.

Now, since we are in a short-sell position, place a stop loss slightly above the fractal and target the swing low of the move as your profit target, as shown in the chart above. The opposite is true if we were in an uptrend. That's it with this strategy!

Nonetheless, it is advisable to backtest each of these strategies to find out which works best for you before trading them with real capital, as this helps you to develop confidence in the system and keep a healthy psychology while trading.

Benefits and Limitations of Fractal Trading

Fractal trading, like any trading strategy, comes with its own set of benefits and limitations. Let's explore both sides of the coin to provide a well-rounded perspective on its use.

Benefits of Fractal Trading

Fractal patterns, unlike some subjective trading methods, are based on specific rules for pattern recognition, reducing the potential for interpretation errors. Fractals also offer traders entry and exit signals, which can be especially valuable for trend-following strategies, or short-term strategies like day trading and the scalping trading strategy. Since fractals are known as accurate signals, they help traders time their trades more effectively, potentially leading to more profitable trades.

Pros

- Fractals are fairly accurate trading signals, which are also easy to recognize and use.
- Fractals can be applied to various timeframes, which is suitable for traders with different trading styles and preferences.
- The use of fractals in setting stop-loss orders contributes to sound risk management practices.

Limitations of Fractal Trading

While fractals are valuable for trend confirmation, they are not infallible. For instance, traders may encounter false signals, where a fractal pattern forms but does not lead to a significant price movement, which can result in losses if not managed carefully.

Cons

- The performance of fractals can vary based on market conditions. For instance, they perform poorly in a ranging market.
- Fractals are inherently lagging indicators, which can sometimes cause traders to enter or exit positions after a significant move has occurred.
- The Fractal pattern rarely occurs on charts.